Morgan Stanley

Putting Stock Market Crashes into Perspective

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Bear Markets Are Normal, Expect Them

With the stock market hitting new highs, fears of corrections are distant memories for many. This is precisely why now is a good time to mentally frame the next correction - before it occurs.

On Aug. 24th, 2015, the Dow Jones Industrial Average experienced its largest intra-day drop (on a points basis) in history[i], terrifying inexperienced investors unfamiliar with the ordinary volatility of the stock market. Coming after a fantastic six-year bull market (now seven years), investors who dollar cost averaged, reinvested dividends, intelligently diversified, and managed their affairs with prudence, grew wealthier.

Not only did their unrealized capital gains expand with each passing year, they enjoyed dividend hikes that turned attractive initial dividend yields into lucrative payouts.[ii] I believe that the correction of 2008-2009 was one of the most opportune times to amass wealth in generations.

Consider that over the most recent seven years, the big-name, mega-capitalization drivers of the stock market have produced huge cash dividend increases. From 2009 to 2016 owners of Johnson & Johnson watched their per share payouts climb roughly 63%; Coca-Cola 71%; Clorox 65%; McDonald's 76%; Exxon Mobil 80%; Colgate-Palmolive 80%; Hershey 102%; Home Depot 207%. [iii]

If you owned these companies, you'd now be collecting a cash yield-on-cost of close to 10%. In other words, the income you would receive as a percent of your original investment. These aren't outliers, they're indicative of the experience equity owners have had by investing in the market for much of the last decade[iv].

What Preceded This Huge Opportunity?

A bear market of course. The great recession of 2008/2009 severely affected several industries yet others only modestly. Regardless of stock prices, profits -- which are the foundation of the value of each enterprise -- made their way into owners' hands as billions of people brushed their teeth, ate a chocolate bar, ordered a coffee, drank a soda, refueled their vehicle with gasoline, stopped for a cheeseburger, or washed their clothes.

Stock Market Crashes of 33% or More Aren't That Unusual

When you look back through history, stock market crashes of 33% or more, peak-to-trough, aren't terribly unique. As the Dow Jones Industrial Average is in excess of 21,000, you should be thinking, "Anything between here and a drop to 13,800 is business as usual; and, in fact, might happen".[v]

Worst Single Day Drops in the Dow Jones Industrial Average

Rank	Date	Close	Net change	% Change
1	October 19, 1987	1,738.74	−508.00	−22.61
2	October 28, 1929	260.64	−38.33	−12.82
3	December 18, 1899	58.27	−7.94	−11.99
4	October 29, 1929	230.07	−30.57	−11.73
5	November 6, 1929	232.13	−25.55	−9.92
6	August 12, 1932	63.11	−5.79	−8.40
7	March 14, 1907	76.23	−6.89	−8.29
8	October 26, 1987	1,793.93	−156.83	−8.04
9	October 15, 2008	8,577.91	−733.08	−7.87
10	July 21, 1933	88.71	−7.55	−7.84
11	October 18, 1937	125.73	−10.57	−7.75
12	December 1, 2008	8,149.09	−679.95	−7.70
13	October 9, 2008	8,579.19	−678.91	−7.33
14	February 1, 1917	88.52	−6.91	−7.24
15	October 27, 1997	7,161.15	−554.26	−7.18
16	October 5, 1932	66.07	−5.09	−7.15
17	September 17, 2001	8,920.70	−684.81	−7.13
18	September 24, 1931	107.79	−8.20	−7.07
19	July 20, 1933	96.26	−7.32	−7.07
20	September 29, 2008	10,365.45	−777.68	−6.98

Exhibit 1[vi]

Assuming your asset allocation is right and you aren't speculating in higher risk individual securities, this shouldn't elicit more than a nod of acknowledgment. If and when this happens, owning quality companies and reinvesting your dividends may lead to the creation of your own fortress balance sheet.

Billionaire Charlie Munger points out that he and Warren Buffett have watched the quoted market value of their equity in Berkshire Hathaway fall by 50% three different times, with little to no change in the earning power of the enterprise itself. Munger, who is known for his no-nonsense delivery, thinks you aren't suited to be a successful investor if you are not prepared for this type of decline.[vii] While that might come off a little harsh, he is has a point. You don't have to invest in stocks to build wealth. Some investors prefer assets without liquidity, such as real estate, even if returns are identical. Logic is not always the default way of looking at the world for most folks.

Single Day "Crashes" of 3% Are Almost Common

As Ben Casselman put it: "Since 1950, the S&P 500 has had one-day declines of 3 percent or more nearly 100 times. It's had two dozen days where it fell by 5 percent or more. Slow-motion crashes, where big declines are spread out over several trading days, are even more common.

But every one of those declines has been followed by a rebound. Sometimes it comes right away. Sometimes it takes weeks or months. But when it comes, it comes quickly. If you wait until the rebound is clearly visible, you've already missed the biggest gains."[viii]

Investor Behavior Creates Winners and Losers, Usually Losers

The annual Dalbar studies show that the average investor has only earned between 40-50% of the market opportunity driven by bad timing decisions.[ix] "They" are the average equity mutual fund investor and "they" almost always buy high and sell low. Now is the time for the "gut" check. Are you financially and emotionally prepared for a big drop? If not, adjust your asset allocation.

How to Survive a Crashing Stock Market

What should you do if the next correction turns into a full-on stock market crash that lasts for years and takes half of your account value with it? The same thing owners of The Hershey Company did between 2005 and 2009 when the stock went from $67.40 to $30.30 per share: Focus on the underlying operations (if earnings and dividends keep rising, all should be fine, especially as part of a diversified portfolio), buy more regularly, and reinvest the dividends.
It might sound boring but it's the way to make large amounts of money over time.[x]

Reinvesting Dividends Can Make Difference

Most people observe it took 25 years for the stock market to recover from the Crash of 1929

A closer look reveals a different story – for those who owned blue chip stocks and were able to reinvest dividends.[xi]

The stock market hit a high of 381 in September of that year, dropped to 41 on July 8th of 1932, and only made it back to the previous high on November 24th, 1954. However, investors who dollar cost averaged and/or reinvested their dividends broke even in about 4 1/2 years, peak-to-trough,[xii] even though the market itself was a fraction of its former value. It's basic math but people don't think about basic math.

What would have happened if you lived through the Great Depression and bought in at the top? At the bottom in 1932[xiii]:

- AT&T was yielding 12.86%
- Standard Oil of California (now Chevron) was yielding 13.33%
- Standard Oil of New Jersey (now ExxonMobil) was yielding 10.00%
- Dow Chemical was yielding 9.09%
- Monsanto Chemical was yielding 9.62%
- General Mills was yielding 10.71%
- National Biscuit was yielding 14.00%
- Chrysler was yielding 20.00%
- General Motors was yielding 13.11%
- Coca-Cola was yielding 10.14%
- Colgate-Palmolive was yielding 10.00%
- Procter & Gamble was yielding 11.00%
- Gillette was yielding 10.00%
- William Wrigley was yielding 12.00%
- J.C. Penney was yielding 16.15%
- Macy's was yielding 11.77%
- American Tobacco was yielding 14.63%
- Reynolds Tobacco was yielding 11.11%
- IBM was yielding 11.32%
- Chase National (now JPMorgan Chase) was yielding 11.84%[xiv].

This was happening while the country was suffering *deflation*, rather than inflation, so the value of each of those dividend payments was rising in real purchasing terms on top of the double-digit yields.

If you're still nervous about stock market crashes, you might want to consider changing your allocation with more cash and bonds. Within the stock portion of your portfolio, dividend-paying stocks tend to fall less during bear markets due to yield support.[xv] Put together a diversified portfolio of great businesses and it's easy to ignore the noise.

Pay a Great Advisor to Help You Do Nothing

Finally, if you have had a tough time waiting out market corrections, seriously reevaluate your strategy and process. You're doing something wrong.

Is this all there is?

These findings apply to most situations, but not to all. A body of knowledge has been gathered through thousands of interactions with sophisticated accomplished professionals.

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[i] "These were the Dow's 10 worst single-day losses ever", Fortune Finance, Tom Huddleston, Jr. March 24, 2015
[ii] S&P 500 Dividends Per Share Historical Data, YCharts, Dividend of SP500 March 2009 was $5.96 and March 2017 $11.72. Almost a double in 7 years which works out to about a 10% compounded return.
[iii] Calculated by the growth in dividends paid in full year 2009 through year end 2016. Source: Value Line.

Dividends Paid

	2009	2016	Dollar Increase	Percent Increase
JNJ	1.93	3.15	1.22	63%
KO	0.82	1.40	0.58	71%
CLX	1.88	3.11	1.23	65%
MCD	2.05	3.61	1.56	76%
XOM	1.66	2.98	1.32	80%
CL	0.86	1.55	0.69	80%
HSY	1.19	2.40	1.21	102%
HD	0.90	2.76	1.86	207%

Source: Value Line

[iv] S&P 500 Dividends Per Share Historical Data, YCharts,
[v] "All-Time Stock Market Highs Are Usually Followed By All-Time…" Munkee, March 2017, "It's time I reminded you how expensive stocks are — a 50% plunge would not be a surprise", Blodget, Business Insider July 2015
[vi] "List of largest daily changes in the Dow Jones Industrial Average" Wikipedia, Dow Jones
[vii] "BBC NEWS Business Charlie Munger Boom and Bust Is Normal", BBC NEWS, October 2009
[viii] "Worried About The Stock Market? Whatever You Do, Don't Sell" Casselman August 2015
[ix] "DALBAR Study Shows Trump Rally Left Average Investor Behind" April 2017
[x] "How to Buy the Most Capital-Efficient Stocks, Safely", February 2012, "If you're a long-term investor who's looking to cash in over many years by reinvesting dividends and watching the investment compound, having a controlling shareholder that's not allowed to sell is the perfect setup. The trust isn't allowed to sell, so it must focus exclusively on improving the results of Hershey – and increasing the payouts."
[xi] "25 Years to Bounce Back? Try 4½" Hulbert, New York Times, April 2009
[xii] IBID
[xiii] The Crash and Its Aftermath: A History of Securities Markets in the United States, 1929-1933, Wigmore, Praeger Publishers, 1985
[xiv] IBID
[xv] "11 Reasons to be a Dividend Growth Investor", Sure Dividend, May 2015

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